Office-Supreme Court, U.S.
FILED
APR 22 1983
ALEXANDER L. STEVAS,
CLERK

No. 82-774

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

PHILIP D. FARMAR AND MARIAN J. FARMAR
AND
A. A. SUGG AND MARY S. SUGG,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

On Writ of Certiorari to the
United States Court of Appeals
For the Federal Circuit
(Formerly the United States Court of Claims)

BRIEF FOR PETITIONERS

MARVIN K. COLLIE
WILLIAM M. LINDEN
Vinson & Elkins
3400 First City Tower
Houston, Texas 77002
(713) 651-2400

JAMES A. CARTER
222 West Harris Avenue
San Angelo, Texas 76902
(713) 653-6724

QUESTION PRESENTED

Under prior decisions of this Court, Section 613(a) of the Internal Revenue Code of 1954 (26 U.S.C.) allows a percentage depletion deduction on oil and gas lease bonuses.

The question presented is whether Section 613A of such Code, enacted by Congress in 1975, by placing a limit on such depletion deduction overturns, *sub silentio*, the prior decisions of this Court so as to eliminate entirely percentage depletion on such bonuses, even though there was oil and gas production from the leases in the year of receipt of the bonuses.

TABLE OF CONTENTS

	PAGE
QUESTION PRESENTED	i
TABLE OF AUTHORITIES	iii
STATEMENT	1
SUMMARY OF ARGUMENT	2
ARGUMENT	4
The Supreme Court's Repeated Examination of the Lease Bonus Allowed Percentage Depletion Thereon — The *Herring* Case, its Ancestor and Progeny	4
A. THE STATUTORY CONSTRUCTION OF THE 1975 ACT REQUIRES CONTINUED ACCEPTANCE OF THE *HERRING* RULE	7
1. The Cross References	7
2. The Roles of the Separate Sections	8
3. "With Respect to" Production	10
4. Correlation of Sections 613 and 613A	12
B. SETTLED RULES OF STATUTORY INTERPRETATION PRECLUDE A CONSTRUCTION OF THE 1975 ACT THAT OVERTURNS *HERRING*	16
C. THE LEGISLATIVE HISTORY OF THE 1975 ACT IS CONSISTENT WITH THE SETTLED TREATMENT OF BONUS INCOME	18
1. Committee Reports on the 1975 Act	18
2. Committee Reports on the 1974 Bill	19
3. Congressional Hearings and Debates on 1975 Act	22
D. THE GOVERNMENT'S POSITION IS INEQUITABLE TO A CLASS OF TAXPAYERS	23
E. IN THE ALTERNATIVE, PETITIONERS HAD ACTUAL EXTRACTION DURING THE YEAR 1976 AND THEREFORE COME WITHIN THE GOVERNMENT'S POSITION HERE	24
CONCLUSION	27

TABLE OF AUTHORITIES

PAGE

Cases:

Anderson v. *Helvering*, 310 U.S. 404 (1940) 4

Burnet v. *Harmel*, 287 U.S. 103 (1932) 4, 5, 13

Canada River Gas Co. v. *Higgins*, 151 F.2d 954 (2d Cir. 1945), *cert. denied*, 327 U.S. 793 (1946) 23

Commissioner v. *Engle*, 76 T.C. 915 (1981), *rev'd*, 677 F.2d 594 (7th Cir. 1982), *cert. granted*, 103 S. Ct. 722 (1983) . 7, 10, 12, 19

Douglas v. *Commissioner*, 322 U.S. 275 (1944) ..... *passim*

Duquesne Warehouse Co. v. *Railroad Retirement Board*, 148 F.2d 473 (2d Cir. 1945), *rev'd on other grounds*, 326 U.S. 446 (1945) 22

Engle v. *Commissioner*, 677 F.2d 594 (7th Cir. 1982), *cert. granted*, 103 S. Ct. 722 (1983) 4, 21, 25

Fleming v. *A. H. Belo Corp.*, 121 F. 2d 207 (5th Cir. 1941), *aff'd sub nom. Walling* v. *A. H. Belo Corp.*, 316 U.S. 624 (1942) 22

Gemsco, Inc. v. *Walling*, 324 U.S. 244 (1945) 20

Helvering v. *Bankline Oil Company*, 303 U.S. 362 (1938) 11

Helvering v. *Morgan's, Inc.*, 293 U.S. 121 (1934) 20

Helvering v. *Twin Bell Oil Syndicate*, 293 U.S. 312 (1934) 6, 9, 18

Herring v. *Commissioner*, 293 U.S. 322 (1934) ..... *passim*

Interstate Natural Gas Co. v. *Federal Power Commission*, 156 F.2d 949 (5th Cir. 1946), *aff'd*, 331 U.S. 682 (1947) 20

Lorillard v. *Pons*, 434 U.S. 575 (1978) 12

Mastro Plastics Corp. v. *NLRB*, 350 U.S. 270 (1956) 16

NLRB v. *Lion Oil Co.*, 352 U.S. 282 (1957) 21

North American Oil Consolidated v. *Burnet*, 286 U.S. 417 (1932) 6

Quintana Petroleum Company v. *Commissioner*, 143 F.2d 588 (5th Cir. 1944) 7, 17

Rugamer v. *Thompson*, 130 N.J. Super. 181, 325 A.2d 860 (N.J. Super. Ct. Law Div. 1974) 20

PAGE

United States v. *American Trucking Association*, 310 U.S. 534 (1940) 20

United States v. *Bennett*, 186 F.2d 407 (5th Cir. 1951) 22

United States v. *Dakota-Montana Oil Co.*, 288 U.S. 459 (1933) 17

United States v. *Lincoln Rochester Trust Co.*, 297 F.2d 891 (2d Cir.), *cert. denied*, 369 U.S. 887 (1962) 20

F. W. Woolworth Co. v. *Commissioner*, 54 T.C. 1233 (1970) .. 22

Statutes:

26 U.S.C. §§ 1-9041 (1976) 2

26 U.S.C. § 611 (1976) 3, 8, 9

26 U.S.C. § 612 (1976) 3, 8

26 U.S.C. § 613 (1976) ..... *passim*

26 U.S.C. § 613(a) (1976) ..... i, 9

26 U.S.C. § 613(d) (1976) ..... *passim*

26 U.S.C. § 613A (1976) ..... *passim*

26 U.S.C. § 613A(a) (1976) 8

26 U.S.C. § 613A(c) (1976) ..... *passim*

26 U.S.C. § 613A(c)(1) (1976) 8

26 U.S.C. § 613A(c)(2) (1976) 24

Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501(a), § 501(b), 89 Stat. 26, 26 U.S.C. § 613(d) (1976) ..... *passim*

SUP. CT. R. 34.1(f) 1

SUP. CT. R. 34.1(e) 1

SUP. CT. R. 34.1(d) 1

SUP. CT. R. 34.2 1

Revenue Act of 1932, § 114(3), 47 Stat. 169 (1932) 17

Revenue Act of 1926, § 204(c)(2), 44 Stat. 9 (1926) 9

Revenue Act of 1926, § 234(a)(8), 44 Stat. 9 (1926) 9

Legislative Materials:

H.R. 2166, 94th Cong., 1st Sess. (1975) 21, 22

H.R. 17488, 93d Cong., 2d Sess. (1974) 20, 21, 22

H. CONF. REP. NO. 120, 94th Cong., 1st Sess. 67 (1975), *reprinted in* 1975-1 C.B. 624 (1975) 19

H.R. REP. NO. 19, 94th Cong., 1st Sess. 3 (1975) 21

H.R. REP. NO. 1502, 93d Cong., 2d Sess. 46 (1974) 20

PAGE

121 CONG. REC. 7813 (1975) 21
121 CONG. REC. 4651 (1975) 21
121 CONG. REC. 4641 (1975) 23

Administrative Materials:

Treas. Reg. § 1.611-1(a)(1) (1982) 5
Treas. Reg. § 1.612-3(a) (1982) 14
Treas. Reg. § 1.612-3(a)(3) (1982) 23
Treas. Reg. § 1.613-2(c)(5)(ii) (1982) 7
Treas. Reg. § 1.613-3(a) (1982) 15
Prop. Treas. Reg. § 1.613A (1977) 22
Prop. Treas. Reg. § 1.613A-4(a)(2) (1977) 16
Prop. Treas. Reg. § 1.613A(d) (1977) 15
G. C. M. 11384, XII-1 C.B. 64 (1933) 5
Rev. Rul. 81-266, 1981-1 C.B. 139 (1981) 17

Secondary Materials:

ARTHUR ANDERSEN & CO., OIL & GAS FEDERAL INCOME TAX MANUAL (11th ed. 1982) 10, 14, 18

Backus, *A Stitch in Time Necessary to Save Lease Bonus Depletion*, 56 TAXES 313 (May, 1977) 10

Bravenac, *Continued Availability of Percentage Depletion of Oil and Gas*, 23 OIL & GAS TAX Q. 204 (1975) 10, 11, 26

A. BRUEN & W. TAYLOR, FEDERAL INCOME TAXATION OF OIL AND GAS INVESTMENTS (1980) 10

Hand, *Thomas Walter Swan*, 57 YALE L.J. 167 (1947) 8

Jones, *Analysis of CA-7 Engle Decision Allowing Percentage Depletion Absent Abstraction [sic]*, 57 J. OF TAX. 230 (October, 1982) 10, 13, 14

Note, *Taxation — Percentage Depletion Not Available with Regard to Advance Royalties Received on Non-Producing Oil and Gas Lease*, 56 TULANE L. REV. 1082 (1982) 10, 13

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

No. 82-774

PHILIP D. FARMAR AND MARIAN J. FARMAR
AND
A. A. SUGG AND MARY S. SUGG,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT
(FORMERLY THE UNITED STATES COURT OF CLAIMS)

BRIEF FOR PETITIONERS

STATEMENT[1]

The Petitioners agree with the Statement of this case (No. 82-774) in the Government's Brief (Gov't Br. 3-9) with the following additional evidence which was not mentioned, but which has never been challenged, by the Government in the Argument of its Brief:

---

[1] Pursuant to Rule 34.2 of the Rules of this Court, the Petitioners have not included items (d), (e) and (f) of Rule 34.1, relating to the Opinion Below, the Jurisdiction of this Court, and the Statutes Involved, respectively, inasmuch as the Petitioners do not disagree with the presentation of such items by the Government (Gov't Br. 1-3). The Question Presented is stated differently.

1. During 1976, the year at issue, oil and gas was discovered in six wells on the leased property (Stip. para. 31, J.A. 10). These six wells in 1976 produced approximately 25,855 barrels of oil and 13,498,000 cubic feet of gas as shown in the production ledger maintained by the Railroad Commission of the State of Texas (Stip. Exhibit K, J.A. 42-46).

2. All of the evidence (the affidavits of the experts, J.A. 47-52) demonstrate that there is an inverse relationship between the amount of a lease bonus and the royalty percentage; as one increases, the other decreases.

SUMMARY OF ARGUMENT

In a series of cases in the 1930's, this Court worked out a comprehensive set of rules for the federal income taxation of a bonus granted in consideration of an oil and gas lease. These holdings were:

1. A bonus payment was an advance royalty paid to the lessor.
2. Since the bonus was a royalty, the lessor was entitled to the greater of cost depletion or percentage depletion, but if production from the lease was not obtained, such depletion deduction had to be restored to income on the termination of the lease.

In 1975, Congress amended the Internal Revenue Code of 1954 (26 U.S.C.) (hereinafter the "Code") by restricting percentage depletion for oil and gas; it retained such depletion for those taxpayers defined as independent producers and royalty owners.[1] This amendment did not mention any change in this Court's rationale as to bonus income for the defined taxpayers. By inference, however, in the same manner as was rejected by this Court in *Herring* v. *Commissioner*, 293 U.S. 322 (1934), the Government would refuse percentage depletion because of

[1] The Tax Reduction Act of 1975, Pub. L. No. 94-12, § 501(a), 501(b), 89 Stat. 26, 26 U.S.C. § 613(d) (1976) (hereinafter the "1975 Act").

such amendment. The Government's position again is wrong because in the context of this Court's opinions, the language of the Code as amended requires continuation of such depletion allowance. Viewing the resulting statutory arrangement in its basic form, each relevant section of the Code has a distinct function: Section 611 is the enabling provision, granting an allowance for depletion; Section 613 is the definitional provision, offering percentage depletion as one of two alternative methods available for computing the allowance (Section 612 offers cost depletion as the other alternative); and Section 613A (the 1975 amendment to the Code) is the volume limitation — that is, the limiting provision which imposes a restriction on the availability of the percentage depletion alternative set forth in Section 613.

The Government claims that the references to "production" in the amendment mean that there must be production from the lease because the amount of the production is necessary to calculate percentage depletion. This is true, but it does not mean that the production must be concurrent with or prior to the bonus. The production can be later but the depletion allowance is still calculated by applying this Court's rationale. The only difference now is that such calculation must take into account the limitation imposed by the 1975 Act. The limitation is applied over the life of the lease in a manner consistent with the principles of this Court's decisions and the Treasury Regulations.

The legislative history of the amendment is scant, but what history there is supports the Petitioner's position here.

In the alternative, since the Petitioners had actual extraction during the year in question, 1976, Petitioners therefore come within the Government's interpretation of the 1975 amendment. The oil and gas attributable to the Petitioners' royalty were sold in 1976 in the normal course of the oil and gas business, but the Petitioners, in addition to receiving the normal proceeds from the produced minerals, also received payments from the lease,

i.e., the bonus. There is no requirement in the statute that the depletable amount be by reference to the regular sales proceeds. The bonus payments by the lessee in 1976 were just as much payments with respect to production because if those payments had not been made, there would have been no production. As the Circuit Court said in the companion case here, *Engle* v. *Commissioner*, 677 F.2d 594, 600 (7th Cir. 1982), *cert. granted*, 103 S. Ct. 722 (1983), even the production of one barrel of oil would have been sufficient, and Petitioners had much more than that minimum.

ARGUMENT

This Court held in *Herring* v. *Commissioner*, 293 U.S. 322 (1934), that a taxpayer who receives a bonus for the execution of an oil and gas lease is entitled to percentage depletion on the amount of that bonus. The sole question in the present case is whether Congress in 1975, *sub silentio*, by some vaguely perceived penumbra of newly enacted Section 613A, changed that result. To answer that question, one must examine: (i) *Herring* and related cases and (ii) Section 613A, the pertinent 1975 amendment to the Code.

The Supreme Court's Repeated Examination of the Lease Bonus Allowed Percentage Depletion Thereon — The *Herring* Case, Its Ancestor and Progeny

An oil and gas lease bonus is an amount of money given by a lessee to a lessor as the consideration for the execution of an oil and gas lease. This money is viewed as the proceeds of the sale of an interest in realty for purposes of most state property laws; but in *Burnet* v. *Harmel*, 287 U.S. 103 (1932), this Court concluded that for federal income tax purposes the lessee's bonus payment was not for the sale of property rights, but instead was an advance royalty paid to the lessor.[3] Hence, the income tax

[3] This was later amplified in *Anderson* v. *Helvering*, 310 U.S. 404, 409 (1940): "Cash bonus payments, when included in a royalty

character of the payment was ordinary income instead of capital gain.

Two years later, in *Herring* v. *Commissioner*, 293 U.S. 322 (1934), this Court extrapolated from *Harmel*, by holding that since the bonus was in the nature of an advance royalty, the depletion tax treatment should be identical to that of a royalty paid with respect to actual production; thus, the greater of cost depletion or percentage depletion deduction was allowable on the bonus.[4] This principle was applicable even if no wells were drilled during the year of the receipt of the bonus and no oil or gas was extracted during such year. This Court held that (1) Congress intended to allow depletion on all royalties, including bonuses, because a bonus is "payment in advance for oil and gas to be extracted. . . . As such it is a part of the 'gross income from the property' . . . to designate the base for the application of percentage deduction," *id.* at 324, and (2) if depletion is to be allowed at all, it must be claimed in the year the bonus is paid.[5]

A decade later, this Court in *Douglas* v. *Commissioner*, 322 U.S. 275, 285 (1944), held that the depletion on an advance royalty[6] is only tentatively allowed subject to the contingency that actual extraction will occur, and "that if the contingency

---

lease, are regarded as advance royalties, and are given the same tax consequences."

[4] This principle is incorporated in Treas. Reg. § 1.611-1(a)(1) (1982).

[5] The resemblance of the Government's position there to that advanced by the Government in the instant case is startling. In *Herring* v. *Commissioner*, 293 U.S. at 325-26, the Commissioner also relied on his own opinion (G. C. M. 11384, XII-1 C.B. 64 (1933)) and urged that since the pertinent section of the 1926 Act provided an allowance for depletion "in the case of ... oil and gas wells," this language excluded situations where no such well existed.

[6] While the Court of Claims in the instant case in an aside posited a question as to whether there is a difference in result between an advance royalty and a bonus, it is believed that no court for federal tax purposes ever has reached such a result and none is urged here by either the Petitioners or the Government.

failed, the suspended sums should fall into income in the year that the failure was manifested by the termination of the lease."

In summary, depletion deductions of oil and gas bonuses are, and always have been, inextricably entwined with the actual extraction or production of oil or gas. [7] Since (1) the bonus is paid in advance of extraction, (2) the claim of right doctrine requires the recognition of the income at the time of receipt [8] and (3) depletion deductions must also be claimed in the same year the income is realized for proper matching, this Court made the tax results compatible with the economic reality. If actual extraction of oil or gas occurred, the bonus was accorded the same tax treatment as any other royalty. If oil or gas extraction did not occur, there could be no royalty and the bonus was treated as ordinary income without depletion. Since the oil or gas extraction results were unknown at the time of the bonus payment, the percentage depletion was allowed tentatively and was subject to being restored to taxable income if no extraction occurred.

A lessor's depletion deduction, however, has never existed in a vacuum; rather, it has always been interdependent with the amount of depletion deductions allowable to the lessee. In *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312 (1934), this Court held that there was a single depletion deduction for any particular oil and gas property, and that this deduction must be apportioned between the lessor and lessee. When a lessor, therefore, claims percentage depletion on a bonus, the lessee must reduce his percentage depletion by exactly the same amount. This is the "bonus exhaustion" rule:

> [I]f the percentage depletion is allowable upon the cash bonus . . . received by the lessor, such bonus must be deducted from the gross income from production received by the lessee in computing depletion; otherwise double

[7] The Government agrees (Gov't Br. 15).

[8] *North American Oil Consol.* v. *Burnet*, 286 U.S. 417 (1932).

percentage depletion deductions would result contrary to the statute.[9]

Thus, considering both the lessor and the lessee, the cycle was complete and by 1944 this Court had established an entire system for the taxation of oil and gas bonuses.

A. THE STATUTORY CONSTRUCTION OF THE 1975 ACT REQUIRES CONTINUED ACCEPTANCE OF THE *HERRING* RULE

The applicable depletion sections of the Code remained unchanged until 1975. In that year, Congress enacted Section 613A of the Code as part of the 1975 Act. The Government contends that this new provision, by merely placing a limit on the amount of each independent producer's and royalty owner's percentage depletion, *sub silentio*, without any apparent consideration, abolished for such producers and royalty owners the entire system of leasehold bonus taxation meticulously established by this Court. The answer to this contention is found in an examination of Section 613A.

1. The Cross References

When in 1975, Congress enacted Section 613A to provide limitations upon the depletion allowance, it retained percentage depletion for a portion of the oil and gas production of independent producers and royalty owners. In a tangled web of cross references,[10] Section 613(d) of the Code, enacted at the

---

[9] *Quintana Petroleum Co.* v. *Commissioner*, 143 F.2d 588, 591 (5th Cir. 1944). The bonus exhaustion rule is also found in Treas. Reg. § 1.613-2(c)(5)(ii) (1982) and accompanying examples.

[10] This legislation has been called a "drafting nightmare," a "mangled statute." *Commissioner* v. *Engle*, 76 T.C. 915, 928 (1981), *rev'd*, 677 F.2d 594 (7th Cir. 1982), *cert. granted*, 103 S. Ct. 722 (1983) (Goffe, J., concurring).

One cannot help repeating the oft-cited comment of Judge Learned Hand:

> [T]he words of such an act as the Income Tax . . . merely dance before my eyes in a meaningless procession: cross-reference to

same time as Section 613A, specifically provided that: "[e]xcept as provided in section 613A, in the case of any oil or gas well, the allowance for depletion shall be computed without reference to this section." Section 613A(a) of the Code adopted reciprocal language by providing that "[e]xcept as otherwise provided in this section, the allowance for depletion under section 611 with respect to any oil or gas well shall be computed without regard to section 613." The exception referred to in Section 613A(a) is found in a further cross reference; Section 613A(c)(1) states that "the allowance for depletion under section 611 shall be computed in accordance with section 613" with respect to a certain amount of each independent producer's and royalty owner's crude oil and gas production.

2. The Roles of the Separate Sections

It is significant that the volume limitation was added by the Act in the form of new Code Section 613A rather than through an amendment to the existing Section 613. Viewing the resulting statutory arrangement in its basic form, each section has a distinct function: Section 611 is the enabling provision, granting an allowance for depletion; Section 613 is the definitional provision, offering percentage depletion as one of two alternative methods available for computing the allowance (Section 612 offers cost depletion as the other alternative); and Section 613A is the volume limitation — that is, the limiting provision which states a restriction on the availability of the percentage depletion alternative set forth in Section 613.

---

cross-reference, exception upon exception — couched in abstract terms that offer no handle to seize hold of — leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.

Hand, *Thomas Walter Swan*, YALE L.J. 167, 169 (1947).

This Court has often recognized the importance of respecting the separate functions of sections of the Internal Revenue Code for purposes of construing a statute. For example, in *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. 312, 319 (1934), this Court observed that Section 234(a)(8) of the Revenue Act of 1926 — the textual predecessor of Section 611 of the Code — is the "granting" provision, and Section 204(c)(2) of the Revenue Act of 1926 — the textual predecessor of Section 613 of the Code — is the provision providing "the method of computation." The functional differences in these provisions has persisted; the addition of Section 613A only adds another functional level to the network of depletion sections, each of which must necessarily be interpreted as an independent member of a group of provisions related only to the extent they bear on the ultimate allowance for depletion.

The functional independence of Section 613 and Section 613A is demonstrated by the different bases employed in achieving the separate purpose of each. Section 613(a) provides that the depletion allowance for an eligible taxpayer is equal to a percentage of *gross income* from the property, whereas Section 613A(c) establishes the eligibility of the taxpayer (i.e., "exempt" from the general repeal of percentage depletion set forth in Section 613A) to the extent of a certain *physical volume* of oil and gas production each day. "Gross income" in Section 613 is the basis to which the applicable percentage is applied for purposes of computation of the allowance; "production" in Section 613A is the basis to which the applicable depletable oil quantity is compared for purposes of determining the extent to which a particular taxpayer is eligible for the allowance as computed. The Government and the Court of Claims have simply confused the functions of the two sections and thus the plain meaning of the language *used in the context of each particular section.*[11]

---

[11] The Government's massive confusion on this point can be clearly seen at p. 23 of the Government's Brief where it is stated that "zero

3. "With Respect to" Production

The substance of the Government's view (Gov't Br. 10-11), as well as that of the Court of Claims (Pet. App. 7a-8a), is that the use of the term "production" in Section 613A requires, in effect, that percentage depletion be with respect to payments that are, in turn, with respect to extraction during the same year.[12] This is an incorrect reading of the statute; there is nothing in it to impose such requirement. Section 613A only requires that the depletion deduction itself (not the payment making up the depletable gross income) be with respect to a given level of production.[13]

---

production times the applicable percentage depletion rate (22%) equals zero." In the statutory method, 22% is never multiplied by barrels of production, but instead is *always multiplied times the dollars of income.*

[12] The Government repeatedly has attempted to bootstrap its position by citation (Gov't Br. 20, 21, 24) of some commentators as supporting its position. It is interesting to review some of the later writers who have looked at the current problem in detail, particularly in light of Judge Fay's comments in dissent in *Commissioner* v *Engle*, 76 T.C. at 961 n.3. For example: ARTHUR ANDERSEN & CO., OIL & GAS FEDERAL INCOME TAX MANUAL 156 (11th ed. 1982); A. BRUEN & W. TAYLOR, FEDERAL INCOME TAXATION OF OIL AND GAS INVESTMENTS, § 7.09[2] (1980); Backus, *A Stitch in Time Necessary to Save Lease Bonus Depletion*, 56 TAXES 313 (May, 1977); Jones, *Analysis of CA-7 Engle Decision Allowing Percentage Depletion Absent Abstraction*, 57 J. OF TAX. 230 (October, 1982); Note, *Taxation — Percentage Depletion Not Available with Regard to Advance Royalties Received on Non-Producing Oil and Gas Lease*, 56 TULANE L. REV. 1082 (1982). All of these commentators, who are the only ones who examine the issue in any depth, either question the position of the Government here or oppose it.

[13] The Government cites Bravenac, *Continued Availability of Percentage Depletion of Oil and Gas*, 23 OIL & GAS TAX Q. 204 (1975), for the proposition that "there is no basis for the court's construction in *Engle* ... that Section 613A turns on sales or income received instead of production" (Gov't Br. 20-21). It is astounding that the Government failed to note that this commentator's conclusions are quite contrary to the Government's arguments and that Bravenac takes a position soundly in favor of Petitioners' position.

Even under Section 613 alone (i.e., prior to 1975) this Court and the Treasury Regulations required that the depletion deduction be "with respect to" production. When gross income and production were coterminous, the depletion was "with respect to" *current* production. As this Court stated in *Helvering* v. *Bankline Oil Company*, 303 U.S. 362, 366 (1938):

> [The depletion allowance] is permitted in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used up in production.

But in the case of bonus payments (again, under Section 613 alone and prior to 1975) gross income qualifying for percentage depletion always was required to be "with respect to" *future* production from the property prior to cancellation of the lease. As this Court stated in the *Douglas* case, 322 U.S. at 284:

> The taxpayer who receives advance royalties receives a gross income but has no statutory right to depletion apart from *actual or prospective extraction.* To grant irrevocable depletion in circumstances where cancellation of the lease

---

Bravenac sees three possible ways to construe Section 613A: (1) that percentage depletion is henceforth to be allowed at the time (and on the amount of the value) of oil and gas production irrespective of the time of receipt (and amount) of gross income, (2) that "production" actually means "sales" and, therefore, percentage depletion should continue to be based upon gross income from the property, and (3) that the computation of percentage depletion will continue to be based upon gross income from the property but that "production" as used in Section 613A means "that percentage depletion will be limited to an amount based on production." *Id.* at 211-12.

Bravenac highly favors alternative (2), which is closest to Petitioners' position here. In fact, Bravenac states, "[T]hus, the construction of 'production' as sales for all purposes under Section 613A(c) is highly desirable." *Id.* at 212. When alternative (2) is applied to bonuses, Bravenac recognizes the practical difficulties of imposing the Section 613A limitation, but states that the difficulty "is capable of solution." *Id.* at 213. Bravenac then suggests a possible solution quite similar to that advanced by Petitioners here. *Id.* at 213 n.22.

> occurs prior to extraction would sever depletion from extraction.

(Emphasis added.)

Since Congress is presumed to enact new legislation with the knowledge of how previous statutes have been interpreted, [14] it is only logical to conclude that when Congress requires percentage depletion to be "with respect to" production in Section 613A, Congress intends the term "production" to have the same meaning as previously applied — *current* production for coterminous gross income and *future* production for bonus income. Of course the "production" requirement of Section 613A adds a precise volumetric limit, whereas the "production" requirement of Section 613 is more general, but otherwise the terms should have identical meanings. This can be summarized: (1) this Court imposed a requirement that the depletion deduction under Section 613 be with respect to production; (2) in the case of bonus income, that requirement meant *future* production; (3) Congress enacted Section 613A with the knowledge of such interpretation; and (4) the production requirement of Section 613A should be interpreted in an identically parallel manner as the production requirement of Section 613 — that bonus income must be with respect to *future* production from the leased property.

4. Correlation of Sections 613 and 613A

Much has been made as to the difficulties if one calculates percentage depletion upon income (as mandated by Section 613) while using limitations based upon physical production of barrels of oil and cubic feet of gas (as required by Section 613A) [15] — as

---

[14] *See Lorillard* v. *Pons*, 434 U.S. 575, 581 (1978).

[15] See the lamentations in *Engle*, 76 T.C. 915, 926 (1981) and in the concurrence of Judge Goffe at pp. 926-40 and in the dissent of Judge Fay at pp. 942-48. *Cf.* Jones, *Analysis of CA-7 Engle Decision Allowing Percentage Depletion Absent Abstraction [sic]*, 57 J. OF TAX. 230, 233 (October, 1982); and Note, *Taxation Percentage*

if such perceived difficulties are a reason not to follow the prior decisions of this Court. These difficulties are avoided if Section 613 and Section 613A are harmonized and reconciled logically. As might be expected, the compatability of these two statutory provisions can be derived from the rationale of *Harmel*, *Herring* and *Douglas*.[16]

As the evidence in the instant case demonstrates, [17] the bonus for an oil and gas lease is interdependent with the royalty retained by the lessor upon execution of the lease. A smaller bonus will command a higher royalty; completely eliminating the bonus will command the highest royalty obtainable. It is thus apparent that the bonus is in fact a replacement for, and is interchangeable with, a certain fraction of additional royalty which is economically equivalent to the bonus. Since economic equivalency exists in the arms-length negotiations of the parties, the federal income tax consequences of a bonus and a royalty also should be equivalent. Otherwise, there is an economic imbalance which this Court avoided in *Herring*.

In this economic setting, *viewing a bonus as an additional royalty (as this Court consistently has done) is the key to harmonizing Section 613 and Section 613A*. As emphasized above, Section 613 requires that the calculation of percentage depletion be based upon dollars, not on barrels of oil or cubic feet of gas extracted. However, Section 613A sets a limit on oil

---

Depletion Not Available With Regard to Advance Royalties Received on Non Producing Oil and Gas Lease, 56 TULANE L. REV. 1082, 1101 (1982). As stated in such Note at 1102: "If a workable solution is available, then the *Herring* precedent and the underlying theories of depletion deduction should militate toward the adoption of such an interpretation of the statute [*i.e.*, for percentage depletion on the bonus]." The Note at 1102-04 then accepts the solution in the dissent of Judge Fay.

[16] *See* pp. 4-7, *supra*.

[17] *See* J.A. 47-52.

and gas percentage depletion based upon barrels of oil and cubic feet of gas extracted. These two concepts are harmonized by:

(1) applying Section 613 to the bonus; and

(2) applying Section 613A to the slice of additional royalty to which the bonus is equivalent.

Under this method, a percentage depletion deduction is allowable on the bonus in the year such bonus is received, irrespective of whether extraction occurs in that year. The bonus dollars then are converted into the slice of royalty which those dollars represent and are allocated over the life of the same oil and gas property in exactly the same manner as the lessor must allocate his basis in such property for calculating his cost depletion.[18] With a certain amount of bonus dollars thus allocated to each unit of the future production during the life of the lease, when oil or gas is extracted and sold those bonus dollars are converted into their equivalent of barrels of oil or cubic feet of gas, depending upon which product is actually produced and sold. The conversion from dollars to barrels or cubic feet is accomplished by applying the actual sale price realized for the products. The bonus barrels of oil are then counted in the lessor's 1000 barrel per day limit along with the barrels of oil resulting from actual extraction during that year. The same method is applied to gas production.

In the event that the taxpayer's actual production plus imputed production from the bonus exceeds the barrel limit, the portion of the percentage depletion deduction taken in the previous year on the portion of the bonus allocable to the year in question (and in excess of the limit) must be restored to income just as the principles of *Douglas* and Treas. Reg. § 1.613-3(a)

---

[18] *Cf.* Treas. Reg. § 1.612-3(a) (1982). This rationale is suggested in the widely-accepted text of ARTHUR ANDERSEN & CO., OIL & GAS FEDERAL INCOME TAX MANUEL 154 (11th ed. 1982); *see also* Jones, *Analysis of CA-7 Engle Decision Allowing Percentage Depletion Absent Abstraction [sic]*, 57 J. of Tax. 230, 233 (October, 1982).

(1982) have required (and still require) in the event that there is not production prior to expiration of the lease. The validity of this proposition can be illustrated by an example[19] which, unfortunately must be almost as complex as the examples in the pro-

---

[19] For example, a bonus of $300,000 is paid in year 1 and equal amounts of production are expected in years 2, 3 and 4. While the lessor realizes $300,000 of depletable income in year 1, for purposes of the limitation in Section 613A the lessor should treat the $300,000 bonus as though he received an additional royalty of $100,000 in each of years 2, 3 and 4. This spreading is feasible because it requires only that the lessor estimate his reserves as he must do for purposes of his cost depletion in any event. He need not estimate his reserves prior to the commencement of production because no spreading need occur until there is production.

Further, assume in year 2 the lessor receives $200,000 in royalties representing 5,000 barrels of oil sold at an average price of $40 per barrel. Again, because the lease reserve estimates (for purposes of cost depletion) indicate that oil extraction will remain constant for three years and then cease, one-third or $100,000 of the bonus should be deemed received in year 2. This $100,000 represents an additional 2,500 imputed barrels (approximately 7 imputed barrels per day) resulting in total production for the year of 7,500 barrels of oil, or approximately 20 barrels per day, which is well below the 1,000 barrel per day limit of Section 613A(c). Thus, it has now been established that at least one-third of the depletion allowance taken on the bonus was justified. The levels of production (from this and other wells of the taxpayer) will determine in years 3 and 4 whether the other two-thirds was justified.

Alternatively, assume the taxpayer has an average daily production of 1080 barrels from other leases in year 2 in addition to the 20 barrels per day for the well under discussion. The applicable barrel limit under Section 613A(c) is 1,000 barrels. The 1080 barrels from the other wells plus 20 barrels from this well produces 1,100 barrels or 100 barrels of excess production. Prop. Treas. Reg. § 1.613A(d)(1977) requires that when a taxpayer's depletable oil quantity exceeds 1,000 barrels per day, the production from each property is reduced proportionately to determine the amount of qualified production. In this case, one-eleventh (100 divided by 1,100) of oil production is disqualified; thus, one-eleventh of his royalty is disqualified. Now for the first time it is known that a portion of the percentage depletion deduction on the bonus must be restored to income (just as would be required if no production occurred). Therefore, one-eleventh of the percentage depletion deduction taken on the $100,000 portion of the bonus allocated to year 2 must be restored to income.

posed Treasury Regulations.[20] In this manner, the volume limitation is added to the depletion framework with a minimum compliance burden on the taxpayer. Moreover, the percentage depletion limitation of Section 613A is accomplished without doing violence to either the separate statutory roles of "gross income" and "production" or well-settled judicial principles regarding the theory of depletion.[21]

B. SETTLED RULES OF STATUTORY INTERPRETATION PRECLUDE A CONSTRUCTION OF THE 1975 ACT THAT OVERTURNS *HERRING*

The *Herring* Court, as discussed above, held[22] that there is no "logical justification" for requiring that production be a prerequisite to the allowance for percentage depletion inasmuch as it is a blatant inconsistency to allow a cost depletion deduction with respect to a lease bonus but to deny a percentage depletion deduction for such income. The identical nature of cost and percentage depletion long-recognized by this Court requires, if at all possible, that the two methods of computing depletion be applied consistently. Nevertheless, the Government, as it did in *Herring*, again asserts that such inconsistency must be the intent of Congress.

Congress should not be presumed to have made such a change, overturning many decisions of this Court in the law of depletion, without "some more explicit expression of its purpose" for "[i]f Congress had wanted to modify that [existing] practice, it could readily have done so by specific provision." *Mastro Plastics Corp.* v. *NLRB*, 350 U.S. 270, 289 (1956).[23]

---

[20] *See* Prop. Treas. Reg. § 1.613A-4(a)(2) (1977).

[21] The importance of respecting the separate functions of Section 613 and Section 613A is discussed at pp. 8-9, *supra*.

[22] 293 U.S. at 328.

[23] In 1932 Congress changed the definition of "gross income" solely for the purpose of computing the percentage depletion deduction by amending what is now Section 613 of the Code to read: "In the case

This Court in *United States* v. *Dakota-Montana Oil Co.*, 288 U.S. 459, 467 (1933) observed that:

> There is no ground for supposing that Congress, by providing a new method for computing the allowance for depletion intended to break with the past and narrow the function of that allowance. The reasonable inference is that it did not and that depletion included under the 1926 Act precisely what it included under the earlier Acts.

So it is here. Congress clearly provided a limitation on eligibility for depletion, but there is no indication it intended that once eligibility was established, depletion meant something different than this Court had worked out under the earlier acts.[24]

---

of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, *excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property.*" Revenue Act of 1932, § 114(3), 47 Stat. 169 (1932). (Amendment in italics.)

[24] The Court of Claims has taken the startling position here that *no one* is entitled to a depletion allowance with respect to the portion of the income from the property represented by the bonus (Pet. App. 14a-15a). This conclusion requires two steps, both of which are wrong. First, the Court of Claims accepts the Government's contention that the lessor is denied depletion under Section 613A. The error of this step is the subject of this case.

The Court of Claims, however, erred a second time in *dictum* in accepting the Government's contention (*see* Rev. Rul. 81-266, 1981-1 C.B. 139 (1981)) that the lessee must nevertheless reduce his depletion allowance by the percentage depletion which (at least prior to 1975) would be allowable to the lessor on the bonus. The court ignored the justification of the "bonus exhaustion rule" as articulated in the *Quintana Oil* case discussed above, which rule was designed to prevent two taxpayers from claiming a depletion allowance on the same income; instead the Court of Claims has twisted the rule to deny *everyone* a depletion allowance on the portion of production income from the property represented by the bonus.

Such result is blantantly inconsistent with the entire theory of depletion established by this Court, for as this Court stated in *Helvering* v. *Twin Bell Oil Syndicate*, 293 U.S. at 321:

C. THE LEGISLATIVE HISTORY OF THE 1975 ACT IS CONSISTENT WITH THE SETTLED TREATMENT OF BONUS INCOME

1. Committee Reports on the 1975 Act

The lower courts have acknowledged that there was no floor debate or discussion in the committee reports on the continued availability of the depletion allowance with respect to bonus income (Pet. App. 11a, 27a, 43a). While this is true, the only pertinent language in the legislative history of the 1975 Act is helpful to Petitioner's position here. In the Conference Report on the 1975 Act it is stated:

> Under the Senate amendment, the deduction for percentage depletion is generally eliminated with respect to oil and gas produced on or after January 1, 1975, with certain exceptions. These include the exceptions provided in the House bill. In addition, the Senate amendment *retains percentage depletion* at 22 percent on a permanent basis for

---

> At all events, . . . the section [the predecessor of Section 613] must be read in the light of the requirement of apportionment of a *single depletion allowance*.... The apportionment gives [the lessee] 27½ per cent. of the gross income from production which it had the right to retain and the [lessors] respectively 27½ per cent. of the royalties they received. Such an apportionment has regard to the economic interest of each of the parties entitled to participate in the depletion allowance.
>
> (Emphasis added.)

Therefore, if the Court of Claims was correct in its first step (denying the bonus depletion to the lessor), it erred in its second step in failing to shift the portion of the aggregate amount of depletion from the lessor to the lessee in accordance with the principle of the *Twin Bell* case. However, the very fact that the language in Section 613 which requires such a shift between lessor and lessee was left intact by the 1975 Act demonstrates that Congress did not intend to deny the depletion benefit to the lessor on the bonus. A leading commentator has recognized the Government's inconsistency in denying percentage depletion on bonus income while implementing the "bonus exclusion rule." ARTHUR ANDERSEN & CO., OIL AND GAS FEDERAL INCOME TAX MANUAL 154-56 (11th ed. 1982).

> the small independent producer *to the extent* that his average daily production of oil *does not exceed* 2,000 barrels a day, or his average daily production of gas *does not exceed* 12,000,000 cubic feet. Where the independent producer has both oil and natural gas production, the *exemption* must be allocated between the two types of production.
>
> . . . .
>
> The conference substitute follows the Senate amendment in providing a small producer *exemption* from the repeal of percentage depletion for oil and gas.

H. CONF. REP. NO. 120, 94th Cong., 1st Sess. 67-68 (1975), *reprinted in* 1975-1 C.B. 624, 629-30 (1975) (emphasis added).

Language such as "retains," "exemption," "to the extent" and "does not exceed" used in this passage reflects that the purpose for the independent producer and royalty owner provision was to limit the availability of percentage depletion to a certain volume of oil and gas.[25] As stated before, there is no indication that there was an intent to redefine the classification of gross income used as the basis for computing the allowance.

The Tax Court in *Commissioner* v. *Engle*, 76 T.C. at 923, would dismiss this language by saying the use of "retains" was only referring to a Senate amendment, but it is this Senate amendment that became the law as to percentage depletion for the independent producers and royalty owners.

2. **Committee Reports on the 1974 Bill**

The Court of Claims (Pet. App. 11a-13a) and the Government (Gov't Br. 24-26) both erroneously placed significant weight on the discussion in the House Ways and Means Committee Report relating to a bill introduced in the preceding Congress. H.R. 17488, 93d Cong., 2d Sess. (1974); H.R. REP. NO. 1502, 93d Cong., 2d Sess. 46 (1974). Inasmuch as this bill (and

---

[25] For example, the word "retain" is defined in *Webster's Third New International Dictionary* 1938 (unabridged ed. 1969) to mean "continue to have."

its report) was never considered (much less voted upon) by the House, the Senate Finance Committee or the Senate, of either the 93d or the 94th Congress, it is clear error to place any weight on such report.

It is a well-settled principle of statutory construction that the interpretation of a provision in an act should not include the history of bills which were not enacted. *See United States* v. *American Trucking Association*, 310 U.S. 534, 550 (1940) (Court noted irrelevance of pending "unadopted" bill for purposes of statutory construction of Motor Carrier Act).[26] Simply stated, the legislative history of an unenacted bill of another Congress is irrelevant.[27]

---

[26] *See also United States* v. *Lincoln Rochester Trust Co.*, 297 F.2d 891, 893 (2d Cir.), *cert. denied*, 369 U.S. 887 (1962) (portions of report discussing language not included in the act as finally adopted may not be relied upon for purposes of interpretation); *Interstate Natural Gas Co.* v. *Federal Power Commission*, 156 F.2d 949, 952 (5th Cir. 1946), *aff'd*, 331 U.S. 682 (1947) ("Certainly the legislative history of a bill that was not adopted cannot be resorted to construe a bill that was"); and *Rugamer* v. *Thompson*, 130 N.J. Super. 181, 325 A.2d 860, 862 (N.J. Super. Ct. Law Div. 1974) ("If a bill covering the same topic never emerges from the committee it has no significant bearing on the matter of statutory construction").

[27] The citation of *Gemsco, Inc.* v. *Walling*, 324 U.S. 244, 246, 264 (1945), by the Government (Gov't Br. 27) as authority for using as legislative history a committee report of a prior Congress is entirely misplaced. The *Gemsco* case solely concerned different versions in the respective bodies of bills in the same Congress on the same subject matter that resulted in a reconciliation in a conference committee and an enactment into law by that Congress.

Petitioners do not disagree with Government's citation of *Helvering* v. *Morgan's, Inc.*, 293 U.S. 121, 126 (1934) (Gov't Br. 27) for that point which this Court actually held. Indeed, it is pertinent to the point here made with respect to related sections (*see* p. 8-9, *supra*), but this case provides no support whatsoever for the attempt to use a committee report on a bill never considered by that or any other Congress.

See also NLRB v. *Lion Oil Co.*, 352 U.S. 282, 291 (1957) (1948 Committee Report is "no part of legislative history" of 1947 Act).

The impropriety of placing any significance on the legislative history of a bill other than the 1975 Act is exemplified by the totally divergent paths taken by H.R. 17488 in 1974 and H.R. 2166 in 1975 (H.R. 2166, 94th Cong., 1st Sess. (1975)), the bill which became the 1975 Act. The 1975 bill originated in the House Ways and Means Committee.[28] However, the 1975 bill as reported out of the House committee contained no provisions as to oil and gas percentage depletion (and thus no independent producer and royalty owner exemption). H.R. REP. NO. 19, 94th Cong., 1st Sess. 3 (1975). This is to be contrasted with H.R. 17488 in 1974 which, as reported out of the House committee in the previous Congress, contained a repeal provision for percentage depletion together with an independent producer and royalty owner exemption different from that ultimately enacted as part of the 1975 Act.[29]

The provision in H.R. 2166 in 1975 regarding the repeal of percentage depletion was added on the floor of the House, although this floor amendment did not include any independent producer and royalty owner exemption. 121 CONG. REC. 4651-52 (1975). The independent producer and royalty owner exemption was introduced into H.R. 2166 in 1975 on the floor of the Senate. 121 CONG. REC. 7813 (1975).

Thus as the Seventh Circuit summarized in the *Engle* case, 677 F.2d at 598:

> **We think that the legislative developments in 1974 and 1975 undercut the Commissioner's reliance on statements pertinent to H.R. 17488. In the Committee version of H.R. 2166, the House *retained* the percentage depletion rules as they then existed. This is the opposite position from that taken by the same Committee in H.R. 17488. It is**

---

[28] The Government inaccurately refers to H.R. 2166 as the "successor" to H.R. 17488 (Gov't Br. 25).

[29] The Seventh Circuit also noted that the producer exemptions in H.R. 17488 and H.R. 2166 were not identical (Pet. App. 25a).

> extremely difficult, as a matter of common sense, to conclude from this pattern that the intent of the House in 1974 remained unchanged in 1975.

(Emphasis in original.) (Pet. App. 24a-25a.)[30]

3. Congressional Hearings and Debates on 1975 Act

The Government has attempted to use the 1975 congressional hearings and floor debates on H.R. 2166 as support for its argument that percentage depletion on a bonus "must be based on current production" (Gov't Br. 27-29), but the quotations cited do not say that; indeed, if these statements mean anything here, they state what the Petitioners urge, that is, the barrel per day figure is a "definition of a small producer" (subsequently entitled in the statute, "independent producers and royalty owners"), not a requirement of production concurrent with the bonus payment for a percentage depletion deduction.

Also the Government would use the same congressional debates to argue that the retention of percentage depletion for the defined group was to encourage further exploration (Gov't Br. 30). No one can dispute that premise, but this leaves the Government's argument with respect to the specific situation of a lease bonus against the congressional purpose. If the bonus is not eligible for percentage depletion there is no percentage

---

[30] It is equally erroneous for the Court of Claims to give weight to the Government's proposed regulations (Prop. Treas. Reg. § 1.613A (1977)) inasmuch as "they carry no more weight than a position advanced on brief by the respondent [the Government]." *F. W. Woolworth Co.* v. *Commissioner*, 54 T.C. 1233, 1265-66 (1970). *Cf.* n.5, *supra*.

Similarly, with respect to the absence of weight to be accorded revenue rulings issued by the Government, *see United States* v. *Bennett*, 186 F.2d 407, 410 (5th Cir. 1951) (ruling of the Commissioner has "no more binding or legal force than the opinion of any other lawyer"); *Duquesne Warehouse Co.* v. *Railroad Retirement Bd.*, 148 F.2d 473, 477-78 (2d Cir. 1945), *rev'd on other grounds*, 326 U.S. 446 (1946); and *Fleming* v. *A. H. Belo Corp.*, 121 F.2d 207, 214 (5th Cir. 1941), *aff'd sub nom. Walling* v. *A. H. Belo Corp.*, 316 U.S. 624 (1942).

depletion incentive for the mineral owner to grant a lease. One may say that if no depletion is allowed, the lessee can simply pay a larger bonus so that the lessor would have the same amount of income after taxes, but such an argument goes against the congressional position that exploration is to be encouraged. The reason is that a lessee who must capitalize the bonus as lease cost[31] simply has less money to purchase leases and to drill thereon. This would be especially true as to those small producers whom percentage depletion is designed to help.[32]

D. THE GOVERNMENT'S POSITION IS INEQUITABLE TO A CLASS OF TAXPAYERS

Not only would the Government's position resurrect an anomaly laid to rest since *Herring* in 1934, but it would introduce a new inequity between taxpayers who opt for bonus payments and those that choose a larger royalty interest. As was shown above, a bonus payment is the economic equivalent of an advance royalty. Hence, to deny percentage depletion to the lessor who receives a bonus payment as consideration, in part, for a lease with respect to his mineral interest rather than an additional royalty is to treat differently two taxpayers who are otherwise similarly situated. For tax reasons a lessor of oil and gas property is forced toward an additional slice of royalty instead of a bonus because the former produces a larger deduction and thereby reduces taxable income.

But it is ironic in light of the congressional debate that the Government's position would penalize the less affluent royalty owner who would opt for the certainty of the bonus rather than a

---

[31] *Canada River Gas Co.* v. *Higgins*, 151 F.2d 954 (2d Cir. 1945), *cert. denied*, 327 U.S. 793 (1946); Treas. Reg. § 1.612-3(a)(3) (1982).

[32] Compare the position of the Court of Claims as set forth in n.19, *supra*, where both lessor and the lessee would lose depletion.

larger royalty.[33] In most cases the only lessor who would demand the largest possible royalty and forego additional bonus would be that taxpayer who already had the assurance of substantial income.

E. IN THE ALTERNATIVE, PETITIONERS HAD ACTUAL EXTRACTION DURING THE YEAR 1976 AND THEREFORE COME WITHIN THE GOVERNMENT'S POSITION HERE

The discussion of the instant case thus far has focused upon the proper allowance of percentage depletion if there is no oil or gas production during the taxable year when the bonus payment is received. However, Petitioners' rights do not depend solely upon a favorable resolution of this issue because royalty oil and gas were actually produced on behalf of Petitioners during the year in which the bonus was received (Stip. para. 31, Exhibit K, J.A. 10, 42-46). The year at issue is 1976. In January, 1976 Petitioners received a bonus payment and during the subsequent months of 1976 oil and gas was produced from the same properties attributable to the bonus payment. Under the provisions of Section 613A(c)(2), Petitioners' average daily production of crude oil for 1976 from these particular properties is determined by dividing Petitioners' aggregate production of oil from these properties (and any other producing properties owned by Petitioners) by the number of days in the taxable year. Thus, during 1976 Petitioners' "average daily production" from these properties was *not* zero as the Government would have this Court believe (Gov't Br. 10, 33).

Hence, even if this Court determines that Section 613A should be interpreted to require "average daily production" during the year of the payment, Petitioners' bonuses qualify for percentage depletion under the facts in the instant case. The

---

[33] *See, e.g.*, 121 CONG. REC. 4641 (1975) (remarks of Rep. de la Garza: "We are only hurting the little people" if Congress repeals percentage depletion for royalty owners).

amount of dollars paid to Petitioners (by the lessees) for this "average daily production" was the aggregate of the bonus *plus* Petitioners' 20% share (under the terms of the lease) of the sale proceeds of actual production during 1976. While the payment to Petitioners for royalty oil during 1976 would be more dollars per barrel than the oil's ordinary selling price, there is absolutely nothing to prohibit a lessee from purchasing royalty oil from a lessor for any price the two parties agree upon. Furthermore, Section 613A(c) imposes absolutely no restriction on the amount of dollars, the gross income, which can qualify for percentage depletion; the only limitation found in Section 613A(c) is upon a taxpayer's *volume* of production. Thus, even if this Court determines, as the Government urges, that Section 613A prohibits percentage depletion unless the taxpayer has "average daily production" during the taxable year, nevertheless, Petitioners in the instant case still qualify.

The Government's position in the *Engle* case (and, in an ambiguous manner, the Government's position before this Court) seems to agree with the above rationale. The Seventh Circuit in *Engle* interpreted the Government's position as allowing percentage depletion on payments made in advance of actual production so long as "one barrel of oil [is] produced from the leased properties during [the year of the payment]." *Engle* v. *Commissioner*, 677 F.2d at 600 (Pet. App. 27a). Under that interpretation of the Government's position, Petitioners' bonuses in the instant case qualify for percentage depletion. In its brief before this Court, however, the Government seems to have shifted its ground. Here, the Government argues that if one barrel of oil is produced during the year of the payment, the taxpayers are entitled to percentage depletion *but only on that one barrel* (Gov't Br. 24). Evidently, it is irrelevant to the Government whether the one barrel is produced before or after the bonus payment, so long as the barrel of oil is produced during the same taxable year as the bonus payment. Petitioners'

bonuses also qualify for percentage depletion under this revised Government theory. Petitioners' wells produced approximately 25,855 barrels of oil and 13,498,000 cubic feet of gas in 1976. For Petitioners' 20% share of this production, Petitioners were paid the advance royalty plus the actual production royalty. All of this amount qualifies for percentage depletion because Section 613A(c) places *no* limit on the amount of depletable *income* per barrel upon which percentage depletion may be claimed and no qualification on how or by whom such payment is made.[34]

Section 613A(c) simply imposes a volume limitation on Petitioner's right to percentage depletion under either the Government's interpretation, or an interpretation consistent with the established principles of this Court, the statute itself, and the legislative history.

---

[34] *See* Bravenec, *Continued Availability of Percentage Depletion on Oil and Gas*, 23 OIL & GAS TAX Q. 204, 212 (1975), cited favorably by the Government (Gov't Br. 20-21). This commentator agrees that if "production" in Section 613A means extraction as the Government here contends (his first of three possible constructions; *see* p. 10 n.13, *supra*), percentage depletion should be allowed on that bonus income. The difference between his position and that taken in this brief is that he would grant the percentage deduction in the years of production to which the bonus is spread. There is an obvious conceptual similarity between this approach and that discussed at pp. 12-16, *supra*.

Under his preferred ("second") approach, i.e., that "production" means "sales," depletion would be allowed when the bonus is received apparently regardless of when production occurs; he notes there is a "crucial determination" to be made in applying the volume limitation "which is capable of solution." *Id.* A solution is advanced at pp. 12-16, *supra*.

CONCLUSION

The volume limitation of Section 613A does not disallow the Petitioners' percentage depletion deductions on lease bonus income received in 1976 because (1) the allowance of such deductions is consistent with the long-standing decisions of this Court, the respective language and functions of the depletion sections of the Code and the relevant legislative history, and (2) in the alternative, the Petitioners in fact had production during 1976 sufficient to satisfy even the Government's interpretation of the statute sought here.

For these reasons, the judgment of the Court of Claims should be reversed.

Respectfully submitted.

MARVIN K. COLLIE
WILLIAM M. LINDEN
JAMES A. CARTER
Counsel for Petitioners

April 22, 1983